

DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER 99-0245
SALES AND USE TAX

For Tax Periods: 1995 Through 1997

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ISSUES

1. Sales and Use Tax-Machinery

Authority: IC 6-2.5-3-2(a), *Gross Income Tax Division v. National Bank and Trust Co.*, 226 Ind. 298, 79 N.E. 2d 651, (1948), *Income Tax Division v. National Bank and Trust Co.*, 226 Ind. 298, 79 N.E. 2d 651, (1948), IC 6-2.5-5-3, 45 IAC 2.2-5-10 (c).

The taxpayer protests the imposition of tax on certain items of machinery.

2. Sales and Use Tax-Inventory Tags

Authority: IC 6-2.5-5-3, 45 IAC 2.2-5-8 (c).

The taxpayer protests the imposition of tax on inventory tags.

3. Sales and Use Tax-Safety Equipment

Authority: IC 6-2.5-5-3, 45 IAC 2.2-5-10 (h) (1).

The taxpayer protests the imposition of tax on certain items of safety equipment.

4. Sales and Use Tax-Cleaning Supplies

Authority: 45 IAC 2.2-5-12 (e).

The taxpayer protests the imposition of tax on certain cleaning supplies.

5. Sales and Use Tax-Paint

Authority: IC 6-2.5-5-5.1, 45 IAC 2.2-5-12.

The taxpayer protests the imposition of tax on paint.

6. Tax Administration-Negligence Penalty

Authority: IC 6-8.1-10-2.1, 45 IAC 2.2-5-10 (h) (1).

The taxpayer protests the imposition of the negligence penalty.

Statement of Facts

The taxpayer is a steel tube manufacturer. The taxpayer's process is akin to that of a "job shop" in that production is driven by custom orders for specific shapes and lengths of steel tubing. After an audit, the taxpayer was assessed additional sales and use tax. Taxpayer timely protested the assessment. Further facts will be provided as necessary.

1. Sales and Use Tax- Machinery

Discussion

Pursuant to IC 6-2.5-3-2(a), Indiana imposes an excise tax on tangible personal property stored, used, or consumed in Indiana. A number of exemptions are available from use tax, including those collectively referred to as the manufacturing exemptions. All exemptions must be strictly construed against the party claiming the exemption. *Gross Income Tax Division v. National Bank and Trust Co.* 226 Ind. 298, 79 N.E. 2d 651(1948). IC 6-2.5-5-3 provides for the exemption of "manufacturing machinery, tools and equipment which is to be directly used by the purchaser in the direct production, manufacture, fabrication . . . of tangible personal property." In *Indiana Department of Revenue v. Cave Stone, Ind.* 457 N.E. 2d 520 (1983), the Indiana Supreme Court found that a piece of equipment qualifies for the manufacturing exemption if it is essential and integral to the production process. 45 IAC 2.2-5-10 (c) further describes manufacturing machinery and tools as qualifying for the directly used in direct production exemption if the machinery and tools have an immediate effect on the property in production.

The taxpayer's first point of protest concerns the imposition of use tax on an uncoiler and flooper. The raw material steel arrives at the taxpayer's plant in the form of a coiled spool of steel. The uncoiler unrolls the steel from the spool. Then the flooper transfers the steel to machines which form and cut the steel to meet the customers' specifications. The taxpayer contends that both of these items qualify for the directly used in direct production exemption. The production process includes the forming,

cutting and welding of the steel. The uncoiler and the flooper are used prior to the beginning of the actual production process and thus do not qualify for exemption.

The taxpayer also protests the assessment of use tax on overhead cranes which are used to replace dies and molds. The cranes do not have a direct effect on the steel which the taxpayer processes into custom steel tubing. Rather, the cranes actually move the dies and molds which process the steel tubing. As such, the cranes do not have an immediate effect upon the steel tubing. The cranes are used outside the direct production process and do not qualify for exemption from the use tax.

Finding

The taxpayer's protest to the assessments on the uncoiler, flooper and cranes is denied.

2. Sales and Use Tax-Inventory Tags

Discussion

The taxpayer also protests the assessment of use tax on inventory tags. The inventory tags display the customer's name or number, the gauge or thickness of the tubing and other pertinent manufacturing information. The taxpayer tracks inventory on their computer system by bundle and location within the plant. Typically, the tags are stapled to skids holding the tubing, taped to the boxes that hold the tubing or placed inside one of the tubes in a bundle with the finished tubes. The finished tubes, including the tags, are then shipped to the customer. A skid or box may contain as few as five pieces of tubing or as many as several hundred pieces of tubing; thus, the tags are used as the skid or box identifier. The inventory tags remain on the bundles of tubing when they are shipped to customers.

The taxpayer contends that these inventory tags qualify for exemption pursuant to IC 6-2.5-5-6, because the inventory tags are incorporated "as a material part of other tangible personal property which the purchaser manufactures, assembles, refines, or processes for sale in his business." This statutory exemption is further clarified at 45 IAC 2.2-5-14(c) as follows:

(c) This regulation does not exempt from tax tangible personal property to be used in production, such as supplies, parts, fuel, machinery, etc., refer to Regs. 6-2.5-5-5(010) and 6-2.5-5-(020) (dealing with material consumed in direct production) for the application of those regulations to taxpayers engaged in the production of tangible personal property.

Inventory control is an administrative rather than a production process. The inventory tags are merely stapled or taped to the boxes and skids holding the tubing

or placed inside the tubing. The inventory tags do not become a material part of the steel tubes as required by the law to qualify for exemption. Further, the inventory tags are primarily used by the taxpayer during the production process for identification of the product and inventory control. The tags are supplies which are used during the production process in an administrative capacity. The cited Regulation clearly does not exempt supplies used during the production process. Therefore, the inventory tags do not qualify for exemption from the use tax.

Finding

The taxpayer's protest to the assessment of use tax on the inventory tags is denied.

3. Sales and Use Tax- Safety Equipment

Discussion

The taxpayer also protests the assessment of use tax on certain items of safety equipment. Safety equipment qualifies for the directly used in direct production exemption found at IC 6-2.5-5-3 if it meets the standard set at 45 IAC 2.2-5-8(c)(2) as follows:

- (2) The following types of equipment constitute essential and integral parts of the integrated production process and are, therefore, exempt. The fact that such equipment may not touch the work-in-process or, by itself, cause a change in the product, is not determinative.

- (F) Safety clothing or equipment which is required to allow a worker to participate in the production process without injury or to prevent contamination of the product during production.

The taxpayer specifically protests the assessment of use tax on hard hats, gloves and coveralls. The taxpayer's production process includes welding metals and cutting steel. These processes can endanger the health and safety of the taxpayer's employees. Therefore the taxpayer provides its employees with hard hats and heavy cotton gloves to protect them during the production process. These items meet the standard of the regulation. The hard hats and heavy cotton gloves qualify for exemption. The taxpayer has not upheld its burden of proof that the coveralls are actually used to protect its employees during the production process. Rather, the coveralls appear to be supplied as a convenience for the taxpayer's employees. Therefore the coveralls do not qualify for exemption from the use tax.

Finding

The taxpayer's protest to the assessment of tax on safety items is sustained in part and denied in part.

4. Sales and Use Tax-Cleaning Supplies

Discussion

Tax was imposed on the taxpayer's purchase and use of cleaning supplies during the audit period. The taxpayer contends that twenty per cent (20%) of the cleaning supplies qualify for exemption because they were used to clean manufacturing machinery. 45 IAC 2.2-5-12(e) provides exemption for items "having an immediate effect upon the article being produced." In this case, the cleaning supplies used to clean the manufacturing machinery have a direct effect upon the machinery. The cleaning supplies do not have an immediate effect on the steel tubes which the taxpayer manufactures. Therefore, none of the cleaning supplies qualify for exemption from the use tax.

Finding

The taxpayer's protest to the imposition of use tax on the cleaning supplies is denied.

5. Sales and Use Tax-Paint

Discussion

The taxpayer contends that the paint, which it sprays on the steel tubing for inventory control, qualifies for exemption because it is consumed in the production process pursuant to IC 6-2.5-5-5.1. That statute is further explained at 45 IAC 2.2-5-12 which states as follows:

(f) Other taxable transactions. Purchases of materials consumed in manufacturing, processing, refining, or mining activities beyond the scope of those described in subsection B above are taxable. Such activities include . . . management and administration; . . .

Inventory control is clearly a management and administrative function rather than a production function. Therefore, the taxpayer's use of the paint does not qualify for exemption from the use tax.

Finding

The taxpayer's protest to the imposition of tax on the paint is denied.

6. Tax Administration- Negligence Penalty

Discussion

Taxpayer's final point of protest concerns the imposition of the ten per cent negligence penalty pursuant to IC 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2 (b) states,

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to reach and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The taxpayer, under different ownership, has been audited on similar issues in the past and continued to fail to accrue use tax on all the taxable items. Many of these items were clearly taxable such as office supplies, soft drinks and snow shovels. The taxpayer's failure to set up an accurate tax accrual system constitutes negligence.

Finding

The taxpayer's protest to the imposition of the negligence penalty is denied.

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